

SUBCOMMITTEE NO. 5

Agenda

Denise Moreno Ducheny, Chair
Robert Dutton
Alex Padilla



Thursday, May 7, 2009
9:30 a.m.
Room 113

Consultant: Brian Annis

Cashflow and Revenue Collection

<u>Item</u>	<u>Department</u>	<u>Page</u>
	<u>Cashflow and Borrowing Issues</u>	
9620	Payment of Interest on General Fund Loans.....	1
	<u>Revenue Collection Issues</u>	
1730	Franchise Tax Board.....	3
0860	Board of Equalization.....	13
9655	Statewide Accounts Receivable Management Enhancements.....	23

Note on the 2009-10 Budget Process: On February 19, the Legislature approved the 2009 Budget Act (SB 1XXX). However, certain items were withheld from the budget, without prejudice, pending a more thorough discussion in the budget subcommittees. Items withheld generally met one or more of the following criteria: (1) were rejected in a prior budget year; (2) have substantial policy implications – for example, information technology of the state's bond capacity; or (3) represent a new program or expansion. Additionally, there are numerous pieces of trailer bill language proposed by the Administration that were not adopted and that require further consideration. The issues in this agenda are these aforementioned issues, April Finance Letters, and other issues of interest to the Subcommittee.

Pursuant to the Americans with Disabilities Act, individuals who, because of a disability, need special assistance to attend or participate in a Senate Committee hearing, or in connection with other Senate services, may request assistance at the Senate Rules Committee, 1020 N Street, Suite 255 or by calling 916-324-9335. Requests should be made one week in advance whenever possible.

9620 Payment of Interest on General Fund Loans

This budget item appropriates funds to pay interest costs on anticipated General Fund borrowing used to overcome cash flow imbalances during the fiscal year. Because receipts and disbursements occur unevenly throughout the fiscal year, the General Fund borrows in most years, even though each budget is balanced when enacted and funds are repaid within the fiscal year. Interest is paid on both internal borrowing (such as cashflow loans from special funds) and for external borrowing (such as Revenue Anticipation Notes (RANs)). The 2009 Budget Act (SB 1XXX) includes \$100 million for interest costs on internal borrowing and \$350 million for interest costs on external borrowing. Funding related to internal borrowing is included in the annual budget bill, but funding for external borrowing costs is continuously appropriated in order to reduce risk for borrowers and lower interest costs.

- 1. Additional Interest Costs (April Finance Letter):** After the passage of the 2009 Budget Act (SB 1XXX), the Department of Finance recalculated cashflow borrowing and now believes additional borrowing will be required, especially in the first few months of 2009-10. The external cashflow borrowing need for 2009-10 is currently estimated at about \$13 billion, which would exceed any past year's borrowing. This higher level of borrowing will result in increased internal borrowing costs of \$50 million (to a new total of \$150 million) and higher external borrowing costs of \$250 million (to a new total of \$600 million). Legislative action is requested only for the internal borrowing because it is a budget bill appropriation. The higher external borrowing costs can be administratively addressed due to the continuous appropriation.

Amendments to Budget Bill Language: In addition to the augmentation, the administration requests the following revisions to budget bill language (changes are underlined). The amendments would essentially allow funds in the budget item to be used for late payment penalties and Registered Warrant (or "IOU") costs. This would help the State fund costs that would be incurred if the Controller has to again delay payments, and possibly take the additional step of issuing Registered Warrants.

Amendments to 9620-001-0001, Provision 3:

In the event that Revenue Anticipation Warrants (RAWs) or Registered Warrants (IOUs) are issued, or considered to be issued, there is hereby appropriated any amount necessary, in excess of the amount appropriated by this item, to pay the expenses incurred by the Controller, Treasurer, Attorney General, and the Department of Finance in providing for the preparation, sale, issuance, advertising, legal services, credit enhancement, liquidity facility, or any other act which, as approved by the Department of Finance, is necessary for such issuance. Funds appropriated by this item shall not be expended prior to 30 days after the Department of Finance notifies the Joint Legislative Budget Committee of the amounts necessary or not sooner than such lesser time as the Chairperson of the Joint Legislative Budget Committee may determine.

Addition to 9620-001-0001, new Provision 5

In the event that the Controller must implement a payment delay plan to manage emergency cash needs with the concurrence of Department of Finance, there is hereby appropriated any amount necessary, in excess of the amount appropriated by this item, to pay the interest expenses, late payment penalties, and other costs incurred by the Controller which, as approved by the Department of Finance, are necessary to implement the payment delay plan. Amounts appropriated pursuant to this provision shall be transferred, upon approval of the Department of Finance, to augment Item 0840-001-0001 of this act. Funds appropriated by this item shall not be transferred or expended prior to 30 days after the Department of Finance notifies the Joint Legislative Budget Committee of the amounts necessary or not sooner than such lesser time as the Chairperson of the Joint Legislative Budget Committee may determine.

Outlook for Cashflow: New estimates for cashflow may be necessary after the May election and May Revision estimates of revenue. The discussion here is based on the outlook at the time the 2009 Budget Act passed in February. Another possible change would be assistance from the federal government in the form of loan guarantees, or other cashflow support to states. Staff understands a representative from the Treasurer's Office will be available at the hearing to discuss how possible federal assistance could benefit the State.

Staff Comment: The Administration should update the Subcommittee on the cashflow outlook, indicating the anticipated RAN or Revenue Anticipation Warrant (RAW) borrowing need.

Staff Recommendation: Approve the April Finance Letter funding request and approve, as placeholder, the DOF budget bill language. Additional measures may be necessary and proposed by the Administration with the May Revision.

Vote:

1730 Franchise Tax Board

The Franchise Tax Board (FTB) administers the personal income tax (PIT) program and the corporation tax (Corp) program. The FTB administers the Homeowners' and Renters' Assistance Programs. The Department also performs some non-tax collection activities, such as the collection of child support payments and other court-ordered payments. The FTB is governed by a three-member board, consisting of the Director Finance, the Chair of the Board of Equalization, and the State Controller. An executive officer, appointed by the Board, manages the daily functions of the Department.

Governor's Budget: The January Governor's Budget proposed expenditures of \$560.3 million (\$524.4 million General Fund) and 5,259 positions for FTB – a decrease of \$6.1 million (\$10.4 million General Fund) and a decrease of 141 positions. The reduction primarily reflects the completion of the Child Support Automation Project and the transfer of ongoing implementation to the Department of Child Support Services.

Adopted 2009-10 Framework Budget: The budget adopted in February (SB 1XXX) differed from the Governor's Budget request in that the amount was reduced to eliminate, without prejudice, the following item to allow for a more thorough Subcommittee review:

- \$3.9 million for the Enterprise Data to Revenue (EDR) Project (see issue # 4).

Tax Gap Measures: Some of the FTB budget proposals include a General Fund cost, but produce an offsetting General Fund revenue benefit. Recent budgets have augmented FTB staff and funding to specifically narrow the "tax gap," or the difference between taxes owed and taxes paid. The 2008 Budget Act included various tax gap proposals – in total the FTB budget was augmented by \$20.1 million (General Fund) and 211 positions – this augmentation was expected to result in a revenue gain of \$118 million (General Fund). Some of the 2009-10 proposals and options in this agenda are directed at further narrowing the tax gap – although the proposals increase expenditures, the costs are expected to be fully offset in new revenues over the long term.

Issues proposed for Discussion / Vote:

- 1. Employee Furloughs and Revenue Collection (Informational Issue):** FTB employees have *not* been exempted from furloughs. Since reduced work hours reduce audit and collection activity, there is concern that furloughs at revenue departments could result in more revenue loss than cost savings. The FTB has implemented 2-day-per-month "self-directed" furloughs. However, many FTB employees are represented by bargaining units affiliated with the Service Employees International Union (SEIU), and should a proposed Memorandum of Understanding (MOU) with SEIU be implemented, the furloughs for those employees would fall to 1 day per month. Under the SEIU MOU, employee wages would be reduced by the equivalent of 1 day per month, but employees would have discretion, in cooperation with management, to work a full schedule and take off furlough days at a later time. The self-directed furloughs would extend through June 2010. Employees would have until July 1, 2012 to use any deferred furlough days.

Information from FTB: According to FTB staff, the savings under the self-directed furlough policy will be roughly \$20 million. However, FTB also estimates that the SEIU 1-day-per-month furlough would result in the loss of \$30 million to \$50 million of revenue (by reducing staff time available for tax administration, audits, and collections). The department indicates that the revenue loss is less than originally anticipated because February data suggest that at least 75-percent of furlough hours are used to *replace* paid leave hours (March data suggest that 51-percent of furlough hours *replace* paid leave hours). Additionally, FTB is implementing other mitigation measures to maintain collection and audit work hours – these measures include: (1) restricting use of vacation time to low-workload months; (2) increasing production hours by canceling or deferring training and meetings; and (3) increasing production hours by delaying or decreasing special project work and initiatives. Overall, the FTB estimates reflect a loss or deferral of about \$1.50 to \$2.50 of revenue for each dollar of savings.

Information from the Department of Finance: The Department of Finance (DOF) indicates that they are not scoring any revenue loss from furloughs at FTB, because they believe FTB will be able to manage (and limit if necessary) staff time off.

Staff Comment: The Subcommittee may want to hear from FTB, DOF, and the LAO on the amount of revenue loss from the furloughs.

Staff Recommendation: Take no action at this time.

- 2. Tax-Gap Options for 2009-10 (from the Legislative Analyst).** The LAO *Analysis* lists several options for the Legislature to consider in this year's budget. If all the LAO options were adopted, a General Fund revenue gain of \$80 million would be realized in 2009-10, growing to \$178 million in 2011-12. The first option on the LAO list is the Financial Institutions Records Match (FIRM) information technology (IT) system – this is agendized separately as issue #3 and should be discussed under that issue. The Administration's Enterprise Data to Revenue (EDR) IT system also has tax-gap features and is agendized separately as issue #4.

Background / Detail: The following LAO table lists the various options. Most of these would apply to FTB, but some apply to the Board of Equalization – Committee Staff has amended the table to indicate the applicable department.

Tax Administration Reforms and Federal Tax Conformity Recommendations^a

(General Fund Benefit, in Millions)

	2008-09	2009-10	2010-11	2011-12
Administrative Modifications				
Implement financial institutions records match system (FTB)	—	\$33.0	\$61.0	\$101.0
Faster use of liens in collections process (BOE)	—	1.0	1.0	1.0
Comply with federal withholding requirement ^b (SCO)	—	—	26.0	1.0
Subtotals Administrative Modifications	(—)	(\$34.0)	(\$88.0)	(\$103.0)
Penalty and Interest Modifications				
Penalize "baseless" overstated claims for refunds (FTB)	\$0.5	\$1.3	\$6.2	\$12.2
Extend period before interest is suspended on tax returns (FTB)	1.3	4.0	4.3	4.7
Increase penalty for failure to file partnership returns (FTB)	—	0.9	1.7	1.8
Assess penalty for failure to file S corporation returns (FTB)	—	0.6	1.0	1.4
Increase penalty for bad checks and money orders (FTB & BOE)	—	0.4	1.0	1.0
Assess penalty if tax preparer understates taxpayer liability (FTB)	—	—	0.3	0.6
Subtotals Penalty and Interest Modifications	(\$1.8)	(\$7.2)	(\$14.5)	(\$21.7)
Fee Modifications				
Modify fees for installment agreements (BOE)	—	\$4.0	\$4.0	\$4.0
Modify and assess fees for offers in compromise (BOE and FTB)	—	0.4	0.4	0.4
Subtotals Fee Modifications	(—)	(\$4.4)	(\$4.4)	(\$4.4)
Federal Tax Conformity Issues				
Partially conform to federal backup withholding (FTB)	—	\$35.0	\$35.0	\$38.0
Conform to the IRS's "kiddie tax" rules for unearned income (FTB)	—	—	15.0	11.0
Subtotals Federal Tax Conformity Issues	(—)	(\$35.0)	(\$50.0)	(\$49.0)
Totals	\$1.8	\$80.6	\$156.9	\$178.1

^a Revenue estimates assume recommendations are effective January 1, 2010, and are net of implementation costs.

^b Estimate reflects total revenues rather than net revenues.

Staff Comment: The LAO should present their options to the subcommittee. Staff understands the Administration is still reviewing these options and would come forward in the May Revision with any proposals they support.

Staff Recommendation: Hold action pending May Revision.

- 3. Financial Institutions Records Match (FIRM) (LAO Option).** FIRM is an IT project that would require financial institutions doing business in California to match FTB information on delinquent tax and non-tax debtors against their customer records on a quarterly basis. The FTB scores the General Fund revenue gain at \$35 million in 2009-10, growing to \$101 million by 2011-12. The 2009-10 cost to begin implementation would be \$3.2 million and total project cost would be \$20.8 million over four years. Last year FIRM was discussed in the Budget Conference Committee – the Department of Finance opposed FIRM, citing no completed Feasibility Study Report (FSR), as is required for new IT projects. The FSR has since been completed, but the Administration has not, to date, proposed the project for the 2009-10 budget.

Background / Detail: FIRM is patterned after the FTB's Financial Institution Data Match (FIDM), a project FTB implemented as a result of federal legislation to identify the assets of delinquent child support debtors. The success of FIDM prompted FTB to extend the asset identification effort – via FIRM – to other classes of debtors. The FTB would use the new data to aid in the collection of debts under the authority of the existing Order to Withhold (OTW) statutes. The proposal would not impact existing law that provides the applicable constitutional due process protections and appeal rights available in either the audit or collection processes. FIRM would take about 18 months to implement, so the 2009-10 revenue gain is accrued back from the date of anticipated collection. The IT system, as proposed, would only include FTB, but the system could be easily modified after implementation to support debt collection for the Board of Equalization (BOE) and the Employment Development Department (EDD).

Policy Bill on FIRM: Senate Bill 402 (Wolk), as amended April 28, 2009, would enact the statutory authority for FIRM, but the bill specifies actual implementation would require an appropriation by the Legislature. The bill includes a provision to reimburse banks up to \$2,500 for implementation and up to \$250 per quarter thereafter. Staff understands that with this provision, no banks are on record opposing this bill. If SB 402 is enacted this year, but no funding is appropriated for 2009-10, the net General Fund benefits of the program would be delayed.

Staff Comment: The FTB should present the FIRM proposal and the LAO and Department of Finance should comment. The Subcommittee may want to consider taking action to adopt this proposal in light of: (1) the budget situation and the projected revenue gain of \$35 million in 2009-10, growing to \$101 million by 2011-12; (2) the fact that there is precedent for this bank records matching with child support collections; (3) that banks are no longer opposed to the measure; and (4) that all taxpayer due process protections would continue.

Staff Recommendation: Approve budget funding (about \$3.2 million General Fund) to begin implementing FIRM in 2009-10, and approve the SB 402 language as placeholder trailer bill language.

Vote:

- 4. Enterprise Data Revenue (EDR) IT Project (BCP and April FL).** As noted earlier, \$3.9 million of funding and 58 positions requested for the EDR project were deleted (without prejudice) in the 2009 Budget Act. That action reflected a desire to give this proposal thorough review in the Subcommittee. This is the initial request for a major new data integration project at FTB that would cost about \$300 million (through 2017-18) to implement. The Administration has since submitted an April Finance Letter that modifies the proposal by accelerating, from January 2010 to July 2009, the hiring of staff such that the 2009-10 costs increase to \$5.2 million. The FTB also estimates that the project will generate about \$2.8 billion of additional revenue over the project timeline, and that ongoing net revenue would be in excess of \$900 million annually.

EDR Budget Proposal and Project Description: The 2009-10 EDR budget proposal consists of \$5.2 million (General Fund) and the addition of 58 positions for FTB to: (1) resolve an existing backlog in business entity return processing and collections correspondence; (2) hire additional staff and consultants to document FTB's business processes as a precursor to development of the EDR Project; and (3) begin planning for the EDR project, including issuing a request for proposals. The FTB estimates that the proposal will increase General Fund revenue collected by \$7 million in 2009-10 and by \$19.9 million in 2010-11, primarily by adding staff to process the current backlog of business entity returns and begin collection correspondence in order to accelerate revenue. The EDR project would take approximately seven years to implement and, once completed, would replace several older FTB information technology systems and streamline other existing systems. The FTB estimates the project will incur costs of \$317 million during implementation (2008-09 through 2017-18) with annual costs thereafter estimated to be \$13.5 million.

Main Goals: The EDR Project has three major goals. First, it seeks to capture all tax return data in an electronic form. Second, the project will integrate the various existing "siloes" tax databases at FTB into a data warehouse. Third, the project will enable FTB to add third-party data (county assessor data, for example) to its data warehouse. The FTB asserts that the EDR Project will allow it to substantially improve detection of underpayment and fraud in order to collect taxes from those who are not paying the full amount that they owe. In addition, the FTB indicates that the project will enable it to improve service and give taxpayers better access to their tax records.

Project Components: The project includes the following improvements to FTB's systems that process personal income tax (PIT) and business entity tax returns:

- An underpayment modeling process that would be integrated with the Accounts Receivable Collections System and Taxpayer Information System.
- An enterprise data warehouse with data search and analysis tools.
- A taxpayer records folder that is accessible to the taxpayer and allows taxpayers and FTB staff to access the information.
- Re-engineering of existing business processes—including imaging of tax returns, data capture, fraud and underpayment detection, tax return validation, filing enforcement, and other audit processes—and integration of these enhanced business processes with FTB's existing tax systems.
- Improved business services at FTB such as address verification, issuance of notices, and a single internal password sign-on for its IT systems.

Benefit-Funded Approach: FTB indicates that it plans to finance the EDR Project using a benefit-funded approach. Contractor payment for system development and implementation will be conditioned on generating additional revenue that will more than cover the cost. This approach is intended to protect the state and also gives the contractors a strong incentive to develop the project in a manner that produces significant revenue quickly. The FTB has used this approach previously.

LAO Recommendation: The LAO originally recommended deferral of this project but has since changed its recommendation to support implementation of the project beginning in 2009-10.

Staff Comments:

1. FTB's benefit-funded approach makes use of revenue gains from reducing the backlog to fully offset costs in 2009-10 through 2012-13. However, these gains can be accomplished regardless of whether project development goes forward. In subsequent years, the estimates in the project's Feasibility Study Report (FSR) indicate large increases in annual revenue gains that would be more directly attributable to the project. From 2012-13 through 2016-17 annual revenue gains increase from \$86.4 million to \$940 million, while project implementation costs increase from \$58.8 million in 2012-13 to a peak of \$111.6 million in 2014-15 and then decline to \$14.1 million by 2016-17.
2. Because the net benefit of this project (as estimated in the FSR) ramps up quickly and becomes very large, the net present value loss to the General Fund that results from delaying the project by one year is somewhere between \$600 million and \$900 million (depending on discount rate). The investment required to avoid this loss is about \$24 million over the next three years (disregarding revenue from backlog reduction). As noted above, the project begins to produce significant net revenues starting in 2013-14. Of course, these calculations critically depend on the accuracy of both the estimates and the schedules in the FSR.

3. The FTB has, perhaps, the best track record in California state government for the successful development and implementation of major information technology projects. However, FTB projects have experienced some significant delays and cost increases, although these problems generally have not prevented successful completion.
4. Due to the large cost of this project and the large projected revenue benefit, the Subcommittee may want to consider adding an annual reporting requirement (if the proposal is approved). An annual report requirement is common with large IT projects, and would keep the Legislature informed of any cost or schedule changes.

Staff Recommendation: Approve the EDR proposal, as revised by the April Finance Letter. Add an annual report requirement.

Vote:

- 5. Staffing for Suspended Senior Homeowners and Renters Assistance (HRA) Program (Staff Issue):** The FTB budget includes \$6.4 million in the current year and \$6.5 million in 2009-10 (all General Fund) for administration of the Senior Homeowners and Renters Assistance Program. This funding supports 79 positions, of which 33 are temporary help. The HRA program provided annual payment to low-income seniors and disabled renters and homeowners. Although the program continues to be authorized in law, the Governor vetoed all funding for payments in the 2008-09 Budget Act, and no funding for payments was included in the Governor's January Budget or in the 2009 Budget Act (SB 1XXX).

FTB Comment: The FTB indicates that it continued to include administrative funding in its budget in the event that funding was restored for the assistance payments. The department also indicates that some ongoing administrative work is needed to process claims for prior years, to maintain the existing data systems, and to fund central administrative costs.

If the program suspension is ongoing, the FTB suggests that the budget could be reduced by \$4.8 million in 2009-10 and by an additional \$500,000 in 2010-11. This would result in the residual funding of \$1.6 million in 2009-10 and \$1.2 million ongoing for FTB operations. The FTB indicates the retained \$1.2 million would be for fixed costs of rent (\$600,000) and the HRA share of centralized information technology maintenance (\$550,000). The FTB would also request to retain \$500,000 and 7 positions for 2009-10 to complete prior-year claims and appeals related to 2007-08 HRA activity.

Staff Comment: While funding for the Senior Homeowners and Renters Program may be reinstated in a better budget year, maintaining staff at FTB for a suspended program seems a luxury the state cannot afford. Presumably, if the positions and funding is eliminated, program staff would be absorbed into vacant positions at FTB. Some program staff may be willing to return to the Senior Program in the future if funding is stored. While some departments claim centralized administration costs for all new positions, the FTB appears to have been conservative in requesting funding for new positions in other areas. Specifically, they have not requested rent funding or centralized IT funding for recently added positions. Given this, their request to retain and shift \$1.2 million for centralized costs seems defensible.

Staff Recommendation: Approve a budget reduction for HRA administration as suggested by FTB – reduce funding by \$4.8 million in 2009-10 and \$5.3 million ongoing. (This results in funding of \$500,000 and 7.0 positions to complete prior HRA workload in 2009-10, and a funding shift of \$1.2 million in centralized costs from the HRA program to other FTB programs).

Vote:

- 6. Implementation of New Tax Credits (April FL#14):** The Governor requests \$663,000 General Fund and 8 positions in 2009-10 and \$145,000 and 1.5 positions ongoing to implement and administer the provisions of SB 15XX and SB 15XXX – two tax credit measures enacted with the February 2009 budget package.

Detail on the New Tax Credits. SB 15XX and SB 15XXX enacted new tax credits, each of which is limited-term with a total credit cap. The credits and costs are as follows:

- **Homebuyer's Credit:** This credit is capped at a total of \$100 million and is available for the purchaser of a new home who would use the home as a principal residence. Homebuyers would receive a state income tax credit of the lesser of 5 percent of the purchase price of the qualified principal residence or \$10,000. Credits are allocated by FTB. FTB requests \$219,000 and 2.8 positions in 2009-10 for associated workload, with no ongoing costs or positions.
- **Small Business Hiring Credit:** This credit is capped at a total of \$400 million and is available as a \$3,000 tax credit for each new full-time equivalent employee at a qualified small business. Credits are allocated by FTB. FTB requests \$289,000 and 3.2 positions in 2009-10 for associated workload, with \$34,000 and 0.5 positions ongoing.
- **Film/Television Production Credit:** This credit is capped at a total of \$500 million with no more than \$100 million allocated each year for five years. Credits can be allocated starting in the 2009-10 fiscal year, but can only be claimed in tax years beginning in 2011. The Film Commission within the Business, Transportation and Housing Agency is charged with awarding the credits. The FTB will have to verify that the taxpayer claiming the credit is in fact the qualified taxpayer allocated credits by the Film Commission or the purchaser of such credits. FTB requests \$154,000 and 2.0 positions in 2009-10 for associated workload, with \$111,000 and 1.0 position ongoing.

FTB Workload: Most of the workload associated with this request is one-time information-technology modifications. Five one-year limited-term Programmer Analyst positions are requested to create new forms, develop a secure transmission process for the receipt of the certifications, make system changes to collect data from the returns upfront, and monitor the allowance of credits. The 1.5 positions ongoing are 1.0 Program Specialist in the audit division (related to the Film Credit) and 0.5 Tax Program Technicians in the Filing Division (related to the Hiring Credit). The ongoing positions would maintain data on credits, answer inquiries, etc.

Staff Comment: The FTB should describe how they are working with the Film Commission to insure that the Commission structures the program in a way that allows appropriate FTB tracking and audits.

The Subcommittee may want to consider the approach of funding one-time implementation costs (such as new forms or information technology changes), but have the FTB absorb the longer-term workload. Since the longer-term workload is

relatively small it should be absorbable within what is already a constantly changing environment with changes in the number of taxpayers, federal law changes, etc.

Staff Recommendation: Approve the one-time information technology workload by approving 5.0 IT positions. Reject the remainder of the 2009-10 request and the 1.5 ongoing positions.

Vote:

0860 Board of Equalization

The Board of Equalization (BOE) administers the sales and use tax programs, administers a variety of business and excise taxes and fees, and oversees the administration of the property tax by county assessors. The BOE is governed by a five-member board, consisting of four regionally elected members and the State Controller. The Board is also the final administrative appellate body for personal income and corporation taxes, which the Franchise Tax Board administers.

The January Governor's Budget proposed expenditures of \$456.5 million (\$256.8 million General Fund) and 4,186.5 positions for BOE – an increase of \$28.5 million (\$17.3 million General Fund) and an increase of 169.8 positions. Much of the staffing increase reflects the annualization of positions added on a partial-year basis in 2008-09, primarily for efforts to reduce the "Tax Gap" – the difference between taxes owed and taxes collected.

2009 Budget Act. The budget adopted in February for the BOE differed from the Governor's Budget request in the following two respects:

- \$13.5 million (\$9.9 million General Fund) was vetoed by the Governor on the basis that the board should be subject to savings equivalent to the amount that would result from applying the Governor's employee furlough order to BOE staff (see Issue #1, later in the agenda).
- \$1.328 million and 5.9 positions that had been requested to implement board regulations imposing distilled-spirit tax rates on flavored malt beverages was deleted (see Issue #2 later in the agenda).

Tax Gap Measures: Some of the BOE budget proposals include a General Fund cost, but produce an offsetting General Fund revenue benefit. Recent budgets have augmented BOE staff and funding to specifically narrow the "tax gap," or the difference between taxes owed and taxes paid. The 2008 Budget Act included various tax gap proposals – in total the BOE budget was augmented by \$29.9 million (\$17.3 million General Fund) and 296 positions, which were expected to result in a 2008-09 revenue gain of \$118 million (\$70.7 million General Fund).

Issues proposed for Discussion / Vote:

- 1. Employee Furloughs and Revenue Collection (Informational Issue):** BOE employees have *not* been exempted by the Governor from the furlough plan. However, BOE indicates that their employees are *not* currently being furloughed because the case is on appeal concerning the ability of the Governor to implement furloughs for workers employed by Constitutional Officers of the State (here the BOE Board). Since reduced work hours would reduce audit and collection activity, there is concern that furloughs at revenue departments could result in more revenue loss than cost savings. If BOE does ultimately implement the furloughs, they would extend through June 2010. Employees would have until July 1, 2012, to use any deferred furlough days.

Information from BOE: According to BOE staff, the savings under the self-directed furlough policy would be roughly \$13.5 million (about \$9.9 million General Fund). The BOE estimates that the furlough policy (by reducing staff time available for tax administration, audits, and collections) would result in the loss or deferral of \$88 million of revenue, of which \$52 million will be General Fund revenue. Overall, this reflects a loss or deferral of about \$6.50 of total revenue for each dollar of total savings—and a loss or deferral of about \$5.25 of General Fund revenue for each dollar of General Fund savings. These BOE estimates assume a one-day per month “self directed” furlough (consistent with the Service Employees’ International Union (SEIU) MOU with the Administration). However, unlike the FTB assumptions, BOE does not assume any offset to furlough days from reduced use of vacation leave. Assuming this offset would reduce the revenue loss significantly.

Information from the Department of Finance: The Department of Finance (DOF) indicates that they are not scoring any revenue loss from possible furloughs at BOE, because they believe BOE will be able to manage (and limit if necessary) staff time off.

Staff Comment: The Subcommittee may want to hear from FTB, DOF, and the LAO on the amount of revenue loss from the furloughs.

Staff Recommendation: Take no action at this time.

- 2. Taxation of Flavored Malt Beverages (January BCP #4):** The Governor's Budget for 2009-10 included a request for \$1.3 million (General Fund) to implement regulations adopted by the Board in April 2008 defining Flavored Malt Beverages (FMBs) as alcoholic beverages that (a) use a fermented malt base (as with beer or ale), (b) are treated to remove the malt characteristics, and (c) to which are added flavorings or other ingredients containing distilled alcohol that constitutes at least 0.5 percent of the final beverage's alcohol by volume. This funding was excluded from the 2009 Budget Act (SB 1XXX), without prejudice, for further Subcommittee consideration. FMBs typically are flavored alcoholic drinks that are sold alongside beer and have similar alcohol contents. Under the regulations, FMBs are taxed at the much higher rates that apply to distilled spirits, rather than as beer or wine. The regulations provide for a rebuttable presumption that all alcoholic beverages, other than wine, are distilled spirits (including FMBs). Manufacturers may present evidence to rebut the presumption that their beverage contains distilled alcohol and be taxed as beer. The Governor's Budget included \$38.3 million of additional General Fund revenue related to this budget request.

Industry Reformulates and Rebuts: Manufacturers of the targeted beverages recently have filed rebuttals with the BOE indicating that they have reformulated their drinks to be below the 0.5 percent distilled alcohol threshold for FMBs. Consequently, BOE is unable to apply the higher tax rates to these beverages.

Revised BOE Request: Given the action of the industry to reformulate their products, the workload assumptions in the budget request are no longer valid. BOE staff have indicated an alternative option of \$250,000 and one position for scientific tests to verify the reformulation.

Staff Comment: The BOE, Department of Finance, and LAO should update the Subcommittee on the status of this issue and indicate their current recommendation on staff and budget funding. The revised BOE proposal would allow the State to verify that producers have indeed reformulated their beverages and to verify that their claim to be exempt from the higher tax rate is valid. However, if the producers did fail the test they would likely reformulate again to avoid the higher tax. It appears that the BOE regulation cannot bring in the anticipated \$38.2 million in new General Fund revenue due to legally-allowable reformulation by producers. Staff notes, that the Legislature could, through tax legislation, impose a higher tax on FMBs regardless of the source of their alcohol. The BOE's regulatory approach was based on the structure of the existing alcoholic beverage tax law.

Staff Recommendation: Reject both the January budget request and the revised BOE request. While it would be desirable to test compliance, it would not ultimately be revenue producing and would, therefore, not be a top priority in a budget year such as this.

Vote:

- 3. Use Tax Voluntary Disclosure Program:** The 2009 Budget Act includes \$126,000 (\$87,000 General Fund) to establish one permanent position to reinstate the Use Tax Voluntary Disclosure Program. This program sunset on January 1, 2008, but was reinstated by AB 3079 (Committee on Revenue and Taxation) of 2008. Under the program, California purchasers of taxable goods who voluntarily come forward and pay unpaid use tax liability receive penalty relief and a shorter statute of limitations period (three years instead of eight years). The BOE estimates that this proposal will increase revenue by \$2.5 million annually—almost a 20:1 benefit/cost ratio.

Assembly Subcommittee Action: The Assembly Subcommittee rejected this request and suggested BOE fund this one position through redirection. Staff understands the Assembly action to suggest that BOE should internally manage their staff resources with ongoing consideration of moving staff from lower benefit-to-cost activities to higher benefit-to-cost activities. There are many revenue-related activities at BOE that have a smaller revenue benefit, so the revenue benefit of this proposal might better be calculated as the revenue from the lower benefit-to-cost activity from which staff would otherwise be redirected from. Additionally, the BOE information indicates that when the program was previously in effect, the workload was absorbed within existing staff.

Staff Recommendation: Reject the budget request (conform to the Assembly action).

Vote:

- 4. New Special Taxing Jurisdictions (April Finance Letter):** The Governor requests \$570,000 (General Fund) and \$1.7 million in reimbursements to permanently establish 22.5 positions to perform the increased workload arising from the establishment of 52 additional Special Taxing Jurisdictions (STJ) since 2005-06. A Special Taxing Jurisdiction generally has the same boundaries as a city or county and is created by the adoption of a local add-on sales and use tax. Generally these local add-on taxes support important transportation, public safety, education, or health and welfare programs.

Background on Special Taxing Jurisdictions: By law, STJs are required to contract with BOE for administration of the district taxes. BOE indicates there are currently 115 STJs in the sales and use tax area. The high number of STJs increases the complexity of tax returns and audits. If this request were denied, BOE would have to redirect staff away from normal audit and collection work negatively impacting the General Fund revenue by approximately \$2 million each year. The budget request is funded primarily through reimbursements from the STJs, but also includes some General Fund due to the fact that all taxpayers are registered and file returns based on all taxing jurisdictions, including STJs, and therefore an employee's work covers both areas.

Staff Comment: While existing law allows the BOE to charge a new Special Taxing Jurisdiction for related administration costs, a budget augmentation is needed to allow BOE to add staff for this workload. According to BOE, the General Fund cost of this proposal is fully offset on the revenue side.

While the majority of this request would be funded from local funds, any additional cost for the locals, as well as the State, is difficult at this time. The BOE's budget has not been augmented specifically for STJs in recent years; however, last year 134 new positions were added in the general audit and collections area as part of the initiative to reduce the tax gap. The Subcommittee may want to consider a measured approach of only funding STJ workload associated with local taxes added since July 1, 2008 – this would cut the requested funding and positions approximately in half. It would require BOE to continue to absorb the base workload from prior years as they did in last year's budget. Additional adjustments could be made in future years as warranted.

Staff Recommendation: Approve half the funding requested – approve 11 positions and approximately \$1.2 million (about \$285,000 General Fund).

Vote:

- 5. Implementation of the temporary 1-cent sales tax (April Finance Letters):** The Governor requests several changes related to the BOE's implementation of the temporary 1-cent sales and use tax increase implemented by AB 3XXX as part of the February budget package. In total, the requests increase General Fund expenditures by \$7.3 million in 2009-10 – this is comprised of \$6.4 General Fund for administrative cost reallocation and \$880,000 General Fund for 13.3 new limited-term positions.

Background / Detail: Under current law, the BOE allocates administrative costs across various revenue recipients based primarily on the amount of revenue collected for each level of government (the state, cities and counties, and Special Taxing Jurisdictions). This cost allocation methodology is found in Revenue and Taxation Code Sections 7204.3 and 7273. With the 1-cent tax increase at the State level, the State's share of revenue collections is increased and that triggers a reallocation of administrative costs for base collection activities. Secondly, the marginal collections associated with the tax increase are not only borne by the General Fund, but rather allocated by the revenue formula – so the cost of the 13.3 new positions would be funded by \$880,000 General Fund and \$342,000 in reimbursements from local entities. While the accounting methodology is defensible, BOE's cost of \$1.2 million for implementing the State tax increase is combined with a \$6.1 million revenue benefit to cities, counties, and Special Taxing Jurisdictions at the expense of the State General Fund. The below table shows the 2009-10 costs of the BOE budget request – similar annual costs would continue for the life of the tax (either 2 years or 3 years depending on voter action on Proposition 1A). The BOE indicates the 13.3 new positions are needed based on their estimate of new workload: (1) 40 additional minutes to complete each audit; (2) 41,000 additional return errors taking an average of 15 minutes to resolve; (3) 72,000 additional calls taking an average of 15 minutes each; and (4) various centralized administration costs.

	General Fund	Reimbursement from locals	Total (net across funds)
Reallocation of base BOE admin costs	\$6,438	-\$6,438	\$0
BOE implementation Cost for tax increase	880	342	1,222
Net General Fund cost	\$7,318		
Net local government benefit		-\$6,096	

Staff Comment: There are really two issues before the subcommittee in this request:

1. Whether the existing statutory cost-allocation methodology should be suspended in the case of the temporary sales tax to lower General Fund

- costs. If the cost allocation were separately calculated for the 1-cent tax, the state General Fund cost would be \$1.2 million and the local cost would be held harmless. The statutory methodology of allocating collection costs among the State and local entities based on revenue shares is fair and good policy. However, here the state is dealing with a temporary tax, and unable to fund many worthy General Fund priorities.
2. The second issue is whether the 13.3 new positions are the appropriate staffing for the marginal cost of the new tax, and if the workload is reasonable, should it be absorbed within the existing budget or funded via an augmentation. The Subcommittee may want to consider the approach of funding one-time implementation costs (such as new forms or information technology changes), but have the BOE absorb the longer-term workload. Since the longer-term workload is relatively small it should be absorbable within what is already a constantly changing environment with changes in the number of taxpayers, local add-on taxes, etc. For BOE, most of the one-time work has been done in the current year, because the tax increase was effective April 1, 2009. Staff understands the Administration is considering a Section 26.00 Letter to internally shift BOE budget funding from facility funding to these one-time costs.

Staff Recommendation: Reject this proposal, including both the administrative cost reallocation (\$6.4 million General Fund), and the new staff for the 1-cent sales tax workload (\$880,000 General Fund). This recommendation is without criticism to the cost allocation methodology, or the BOE workload calculations – it is simply based on the General Fund condition.

Vote:

- 6. BOE Headquarters Building:** The enacted 2009 Budget Act (SB 1XXX) includes an augmentation of \$5.7 million (\$3.3 million General Fund) to establish 6 permanent positions and to relocate about 500 employees from the current Sacramento headquarters building at 450 N Street, including the establishment of 6 permanent positions to handle the relocation and also for leasing and relocation work at other BOE sites. The budget estimates that the annual cost of this proposal will grow to \$8.5 million in 2010-11 and subsequent years.

Background: The HQ building has a long, sad, and expensive history of problems. Construction was completed in 1993. The original owner was CalPERS, and the state leased the building on behalf of BOE. The state purchased the building several years ago because financing a purchase appeared more cost-effective than the ongoing lease payments. However, the building has a history of construction defects causing water leakage, mold, and glass falling out of the building curtain wall. A major project to replace the curtainwall glass and seals and to remediate areas of water leakage was completed in 2006. Leakage problems, other building system problems, and employee complaints of building-induced illness continue nevertheless. According to BOE, bond financing for the purchase was never completed due to the ongoing problems and temporary financing from the Pooled Money Investment Account remains in place. Compounding this situation, in March of this year, a major hot water pipe burst flooding several floors.

Occupancy Exceeds Design Level: The BOE indicates that the recommended maximum occupancy for the building is 2,200 and that estimated occupancy will exceed this level by 415 in the current year. The Board indicates that leasing additional space and reducing crowding is necessary to maintain employee productivity and morale and to protect the health and safety of employees because the building's HVAC and other systems are being stretched and because remediation of ongoing problems requires continually shifting employees out of the areas affected by the remediation work.

Options Under Consideration: The \$5.7 million appropriated in the 2009 Budget Act is a partial step in resolving issues with the headquarters building. Repairs are needed for water-related damage in many restrooms and for the recent major pipe burst. The multiple problems over multiple years have resulted in calls to perform a more extensive overhaul or to sell the building. The Department of General Services provides a list of options that are being analyzed for cost and risk:

1. Move BOE out of building, repair when empty, then re-occupy.
2. Repair, while occupied by BOE, utilizing "swing space" within the building where employees are temporarily relocated two floors at a time.
3. Repair floors, while occupied, by sealing off the work areas and directing employees to restrooms and breakrooms on other floors.
4. Sell the building.

Staff understand that BOE and DGS are working together to analyze these options, but at the time the agenda was finalized, there was no specific proposal from the Administration.

Related Budget Issues: BOE changed their costing for the “Facilities Operations” component (rent cost) of new positions from the \$2,819 used last year to \$11,351 for new Headquarters positions and \$6,040 for new district positions. This new costing is included in new positions approved in SB 1XXX and in April Finance Letters. This new costing appears high for either methodology of (1) costing for the actual marginal cost of the new positions, or (2) costing based on the overall average for base and new staff. The higher costing seems instead related to the facility issues in this BCP #1. Those costs related to problems with the headquarters building should already have been included in BCP #1, so a budget reduction to use last year’s costing of \$2,819 per position (instead of either \$11,351 or \$6,040) would seem appropriate. BOE indicates another cross-cutting issue is what was budgeted for new positions related to workstations. BOE staff reviewed the costing and indicate \$7,500 per position was double-counted. Therefore, BOE indicates a budget reduction of \$285,000 is necessary to correct for the double-counting.

Use of Bond Funding: The BOE budget includes \$5.9 million to pay the cost of bond debt service. However, this cost would not be incurred if the facility bonds are not sold in 2009-10 and discussions with the Administration suggest it is very unlikely the bonds can be sold in 2009-10 given problems with the building. In the recent past, the BOE has redirected the bond debt-service funding for mold and water mitigation and repair costs. BOE and the Department of General Services indicate there are water and mold mitigation costs, in 2009-10 that go beyond funds appropriated for that purpose. It seems likely the Administration would again in 2009-10 shift the \$5.9 million for bonds debt-service to building repairs. Given that this is the likelihood, the Subcommittee may want to consider a budget action to correctly score the \$5.9 million as building repairs instead of debt service (this would not amend the budget bill, but rather indicate the adjustment in the Department of Finance Changebook budget tracking system).

Staff Comment: Problems with the facility are costing the State money and causing inconvenience for BOE employees. A sizable number of BOE employees have also filed workers compensation claims or otherwise reported negative health consequences. These issues make a comprehensive resolution plan essential. It is not clear, however, that BOE, DGS, and the Department of Finance will be able to develop a comprehensive plan during this spring’s budget process.

Staff Recommendation: Take the following action in addition to the \$5.7 million already approved in the 2009 Budget Act:

- Shift the \$5.9 million for bonds debt service to building repair (this would likely occur anyway through internal redirection).
- Fix the facilities / general expense budgeting in the other BCPs and Finance Letters: cut \$286,000 for workstation double-counting, and cut \$1.1 million for

over-budgeted per employee rent costs (these changes would also have to be adjusted to conform to action on the BCPs and FLs in other issues).

Vote:

9655 Statewide Accounts Receivable Management Enhancements

This budget item is newly created in the 2009-10 budget to provide centralized budget authority for statewide accounts-receivable management enhancements. In this case, Accounts Receivable (AR) are outstanding obligations owed to the State including taxes, fees, penalties and other payments. The new funding in the budget is \$8.3 million (\$3.3 million General Fund) and gross revenue gain is anticipated at \$32.5 million (\$13.8 million General Fund). The budget funding in this item supports two efforts: (1) \$197,000 for two new positions (two-year limited-term) at the State Controllers Office (SCO) to centrally track statewide AR and (2) \$8.1 million to pay for private collection agency fees or departmental costs for collections work. This proposal would affect both revenue and non-revenue departments – i.e., it would affect the Board of Equalization (BOE) and the Franchise Tax Board (FTB), but also departments such as the Department of Motor Vehicles, the California Highway Patrol, and the State Lands Commission.

The enacted 2009 Budget Act (SB 1XXX) included the Governor's proposed funding of \$8.3 million for this new item. However, to fully implement the proposal, trailer bill language must also be adopted and action on statutory changes was withheld from the adopted budget package, without prejudice, to allow for a thorough Subcommittee review of the proposal.

1. Administration Accounts Receivable Proposal for 2009-10: As indicated above, the Administration requests new budget funding and statutory change to improve the State collection of accounts receivable. The proposal includes the following main components:

- Establish 2.0 new limited-term positions at the SCO and \$197,000 to collect and analyze AR data from departments and to periodically report on the results of this effort for policy considerations and for management action.
- Establish a new mechanism to pay for private collection agencies fees, which could generate a net gain of up to \$19.8 million (up to \$7.8 million General Fund).
- Establish general statutory authority to allow all departments to charge a fee for their costs of collecting delinquent ARs, potentially increasing revenues up to \$1.4 million. Amend existing statute to allow the Board of Equalization (BOE) to add the contingency fee for in-state private collection agencies' fees to tax liabilities, potentially increasing revenues up to \$3.2 million.
- Revise statute to increase the size of ARs departments can internally discharge from \$250 to \$500.

Current practice: The State Administrative Manual (SAM) provides direction to departments for collection of ARs. Departments are generally directed to send three letters in an attempt to collect ARs and then can turn the debt over for collection by private collection agencies. Practices vary somewhat at the tax collection departments. Initial surveys by the administration indicate that over \$6.3 billion in ARs are outstanding. Few departments, only 9 out of 40 in a recent review, use private collections agencies. For those that do use private collectors, collection

rates range from 1 percent to 40 percent. Under current practice, private collectors receive a share of any collections – the Administration indicates it would explore another option of the sale of ARs, such that the purchaser assumes all risk of collection, but keeps 100 percent of debt collected.

Another option for some departments is to turn over non-tax collections to the Franchise Tax Board. Statute defines certain non-tax collection activity for FTB such as collection of child support and court-ordered debt. Departments can also turn debts over to FTB, and if the debtor has a tax refund due, the refund is instead redirected to debt payment.

Problems indicated with current practice: The four components of the request (listed above) seek to address the following issues:

- Centralized data on department ARs is not compiled – records are only kept at the department level. This hampers transparency, but also reduces the opportunity of the state to package and sell ARs.
- No flexible mechanism exists to pay private collectors when they are successful in collecting ARs – departments must fund this out of their base budget or request additional funds through the annual budget process.
- No general statutory authority exists for departments to charge a fee for the cost of collection for delinquent ARs.
- Current statute limits the amount that departments can internally discharge (or drop from the books as uncollectible) to \$250. The administration argues this should be increase to \$500 to focus department efforts on more cost-effective AR collection.

Staff Comment: The Department of Finance should present this proposal to the Subcommittee. The BOE and FTB should comment on this proposal relative to their collection experience and explain how this proposal might affect their work. Additionally, the Administration should speak to the use of private collectors, versus the option of State staff, such as additional positions at FTB.

Since existing statute allows for use of private collections agencies in most cases, this proposal seems to more facilitate existing departmental use of private collections agencies, than to chart a new direction in state policy. At the same time, it would be helpful to understand the cost and effectiveness of private collectors versus state employees, and the Administration indicated no such analysis has been performed.

Staff Recommendation: Approve this request – both budget and placeholder trailer bill language. Add a legislative reporting requirement so the Budget Committee can stay apprised of Administration activities in this area.

Vote: